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THE RANKING OF POLICY INTERVENTIONS UNDER FACTOR  
MARKET IMPERFECTIONS: THE CASE OF  
SECTOR-SPECIFIC STICKY WAGES AND UNEMPLOYMENT\*

Jagdish Bhagwati and T. N. Srinivasan

Number 100

February 1973

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\* The research underlying this paper was supported by the National Science Foundation. The views expressed herein are the authors' responsibility and do not reflect those of the National Science Foundation, the Department of Economics nor of the Massachusetts Institute of Technology.

## THE RANKING OF POLICY INTERVENTIONS UNDER FACTOR MARKET IMPERFECTIONS:

### THE CASE OF SECTOR-SPECIFIC STICKY WAGES AND UNEMPLOYMENT

The ranking of alternative policy interventions for an open economy characterised by factor market imperfections has been the subject of active analysis in recent years.

The imperfections analysed hitherto can be distinguished into two major types: (1) where the source of imperfection is a (distortionary) wage differential between sectors, while the wage is perfectly flexible; and (2) where there is no wage differential between sectors but the (uniform) wage is "sticky" and unemployment follows. The former class of problems was first analysed by Hagen (1958) and has been the subject of further welfare analysis by Bhagwati and Ramaswami (1963), Kemp and Negishi (1969) and has been resolved fully in Bhagwati, Ramaswami and Srinivasan (1969).\*

The latter problem was raised by Haberler (1950) and treated further in Bhagwati (1968), Johnson (1965) and has been resolved fully by Brecher (1970).\*\*

A recent model of Harris and Todaro (1970) has the interesting property that it combines both the sticky-wage and the wage-differential phenomena as the outcome of a sticky wage in one (urban) sector. By postulating that

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\* (1) The "dual" problem of raising the employment of a factor in one sector beyond the level implied by the optimal solution, and ranking different ways of doing this in terms of the loss entailed, has been solved by Bhagwati and Srinivasan (1969). See Bhagwati (1971) for a discussion of the parallel between these different analyses. (2) The "positive" analysis of the various pathologies which result in consequence of the presence of a distortionary wage differential has been attempted by a number of writers recently, including the present authors (1971), and a most useful review of this literature can be found in Magee (1972).

\*\* A valuable analysis of this problem, where the two-sector model is not the traditional model with primary factors producing two final, traded goods, but instead one with an investment good and a consumption good, is by Lefever (1971).

the wage in the other (rural) sector will be equated with the expected wage in this (urban) sector, the expected wage being the actual wage adjusted for the probability of securing the wage/job (which is less than unity in the presence of unemployment), Harris and Todaro essentially solve their system to yield urban unemployment (as the urban labour force exceeds the labourers who will be employed at the "sticky" wage) and a differential between the actual wages in the two sectors (as only the actual rural wage and the expected urban wage are equalised).

In this paper, we propose to analyse this model of market imperfection and rank alternative policy interventions in the presence thereof. Since the model permits unemployment, we also investigate the optimality properties of alternative policies in regard to their effects on employment levels, whereas Harris and Todaro formally discussed welfare improvement and maximization in terms of a social utility function defined on aggregate consumption of goods alone.\*

### I: The Model

The basic Harris-Todaro model consists of a set of relations which can be stated as follows.

There are two commodities (A and M), produced in quantities  $X_A$  and  $X_M$ , using  $L_A$  and  $L_M$  units of labour, with strictly concave production functions: \*\*

$$X_A \leq f_A(L_A) \quad (1)$$

\* For an earlier, formal analysis of social utility functions, augmented to allow for "non-economic" objectives such as self-sufficiency, see Bhagwati and Srinivasan (1969).

\*\* Thus, implicitly, there is a second factor ( $K_A$ ,  $K_M$ ) which yields the diminishing returns to labour input.

$$X_M \leq f_M(L_M) \quad (2)$$

Next, with the fixed, overall labour supply assumed by choice of units to equal unity, we have:

$$L_A + L_M \leq 1 \quad (3)$$

$$L_A, L_M \geq 0 \quad (4)$$

to complete the "supply" side of this general equilibrium system. It is well known, of course, that if we now add a standard utility function:

$$U = U(X_A, X_M) \quad (5)$$

where  $U$  is concave with positive marginal utilities for finite  $[X_A, X_M]$ , this function would be maximised when:

$$\frac{U_1}{U_2} = \frac{f'_M}{f'_A} \quad (6)$$

together with the satisfaction of equalities in equations (1)-(3), (where  $U_1$  and  $U_2$  represent the partial derivatives of  $U$  with respect to  $X_A$  and  $X_M$  respectively and  $f'_i$  is the derivative of  $f_i$  with respect to its argument,  $i = A, M$ ).\*

A competitive economy will indeed be characterised by this maximum. Figure 1 shows that the production possibility curve will be DE and, with  $\frac{U_1}{U_2}$  given by (the negative of the slope of)  $SS'$ , the economy will produce optimally at S. For a closed economy, the reader can thus visualise a tangency of the indifference curve to DE at S; and for an open economy, the reader can

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\* We are, of course, ruling out throughout this paper a corner solution, the sufficient conditions for doing this being that  $f'_A(0) = f'_M(0) = \infty$ .

visualise the tangency of the indifference curve to  $SS'$  at a point other than  $S$ , in the usual way.\*

The Harris-Todaro problem of sector-specific rigid wages and resulting unemployment can now be readily introduced. Let the optimal solution above [and at  $S$  in Figure 1] be:  $X_A^*$ ,  $X_M^*$ ,  $L_A^*$ ,  $L_M^*$  ( $= 1 - L_A^*$ ). Assume now, however, that there is an exogenously specified, minimum-wage constraint in manufacturing, such that:

$$w \geq \bar{w} \quad (7)$$

where  $w$  is the wage in manufacturing, in units of the manufacturing good (M). For a competitive economy, this implies that

$$f_M'(L_M^*) \geq \bar{w} \quad (7')$$

This constraint becomes binding, and  $S$  in Figure 1 is inadmissible, when:

$$f_M'(L_M^*) < \bar{w}$$

The competitive economy, when characterised by this wage constraint, will then experience unemployment of labour. We then have two options to characterise the labour market equilibrium in this situation: either assume that the wage in agriculture (A) will be equalised with the wage in manufacturing (M) despite the unemployment; or that the wage in agriculture will be equalised with the expected wage in manufacturing, the expected and the

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\* In the diagrammatic representation in Figures 1 - 5, we have depicted alternative equilibria at constant  $U_1/U_2$ , thus implying a linear utility function. This also makes the diagrams interpretable as depictions of the production equilibrium for an open economy, with given terms of trade. The formal analysis in the text is, of course, independent of any such restriction of linearity; it does not however extend to the case of an open economy with monopoly power in trade.

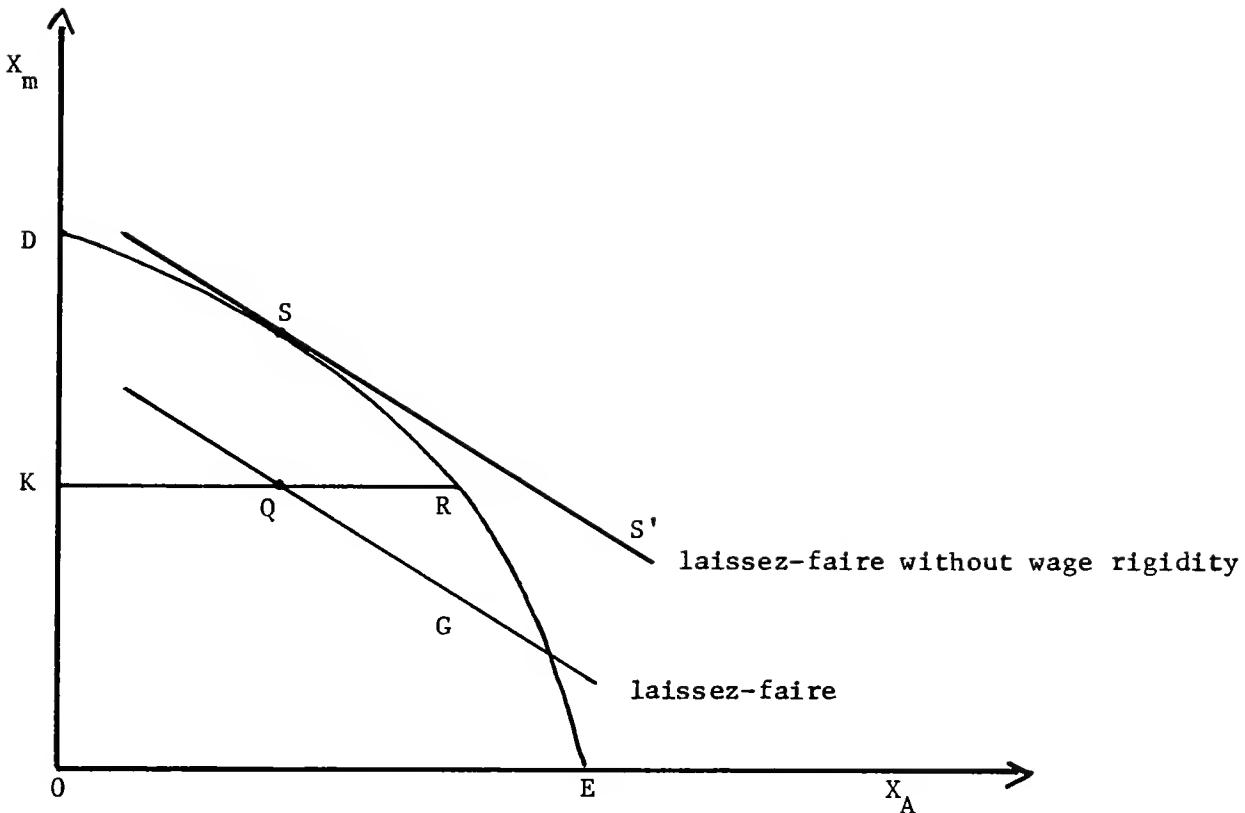


Figure 1

DE is the production possibility curve when wage rigidity is absent. With the wage rigidity constraint, equilibrium production under laissez faire can lie only along RK instead of RD, because equilibrium on RD (excluding R), as at S, implies wage in manufacturing below the minimum wage. Q is the laissez-faire production point under price-ratio QG, under the wage constraint.

actual wage in manufacturing being different as the former would be defined as the latter weighted by the rate of employment

$$\bar{w} \frac{L_M}{1-L_A}$$

where  $L_M < (1-L_A)$  when there is unemployment.

The analysis of Harris-Todaro is based on the latter assumption, so that we can then write the equilibrium production conditions in competition and laissez faire, as follows:

$$f_M' = \bar{w} \quad (8)$$

$$\frac{U_1}{U_2} f_A' = \bar{w} \frac{L_M}{1-L_A} \quad (9)$$

where we assume, in (9), that the consumption and production price of the agricultural good is identical and equal to  $U_1/U_2$ . Given  $\bar{w}$ , we can then solve (8) and (9) for  $L_M$  and  $L_A$ , after setting  $X_A = f_A(L_A)$  and  $X_M = f_M(L_M)$ . The laissez-faire equilibrium, with unemployment ( $L_M < 1-L_A$ ), will then lie, in Figure 1, along RK (where  $X_M$  and hence  $L_M$  are fixed at the value that makes  $f_M' = \bar{w}$ ) at Q.\*

The policy questions that immediately arise are: (i) what is the optimal policy intervention which would restore the economy to optimality at S; (ii) what alternative policies can be used in this model for intervention, and what would be their impact on welfare (as conventionally defined by our utility function) and on unemployment?

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\* It is worth noting that the laissez-faire equilibrium would lie along RK even if we assumed actual wages to be equalised between the two sectors.

### II: The Basic Results

In this model, there are a number of policy options which can be explored; however, many can be shown to be equivalent to one another or to combinations of other policies.

Thus, we will discuss the following policies:

(i) laissez faire;

(ii) wage tax-cum-subsidy in manufacturing (M); and

(iii) production tax-cum-subsidy.

Note that, as a little reflection will show, the simple structure of the model implies that:

(iv) a wage tax-cum-subsidy in agriculture is equivalent to policy (iii);

(v) a uniform wage tax-cum-subsidy in all employment is a combination of policies (ii) and (iii);

(vi) for a closed economy, a consumption tax-cum-subsidy policy is equivalent to policy (iii), i.e. a production tax-cum-subsidy policy;\* and

(vii) for an open economy, a tariff (trade subsidy) policy would, as usual, be equivalent to policy (iii), i.e. a production tax-cum-subsidy policy, plus consumption tax-cum-subsidy policy.\*\*

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\* Thus, let  $\pi_p = \frac{\bar{w}_M}{(1-L_A)f_A}$  be the producer's price of the agricultural good, and  $\pi_c = \frac{U_1[X_A, X_M]}{U_2[X_A, X_M]}$  be the consumption price of the agricultural good. The production tax-cum-subsidy is then defined as  $\frac{\pi_p - \pi_c}{\pi_c}$ , and the consumption tax-cum-subsidy as  $\frac{\pi_c - \pi_p}{\pi_c}$ .

\*\* Thus, if  $\pi^*$  is the international price of the (importable) agricultural good, a tariff at ad valorem rate  $t$  would imply:  $\pi^*(1+t) = \pi_p = \pi_c$ .

We will proceed to establish the following propositions, which we now illustrate with the usual diagrammatic techniques:

Theorem I: There exists a unique competitive equilibrium corresponding to each wage subsidy  $s$  to manufacturing in an interval  $[0, \bar{s}]$ . At  $\bar{s}$ , full employment is reached.

Thus, imagine in Figure 2 that the laissez-faire equilibrium is at  $Q$  (as in Figure 1). Succeeding levels of wage subsidies should map out a locus of resulting production equilibria, with  $H$  representing the full-employment equilibrium, the wage subsidy that leads to it being  $\bar{s}$ .\*

Theorem II: A wage subsidy (in manufacturing) will exist which will improve welfare over laissez faire.

Thus, laissez faire (i.e. wage subsidy = 0) can be necessarily improved upon by some wage subsidy. Thus, in both Figures 2 and 3, where we illustrate for the case of a linear utility function (or, equivalently, for the case of a "small," open economy), the curve  $QH$  must necessarily lie somewhere to the northeast of  $QG$ , whose slope defines  $U_1/U_2$  (or, equivalently, for a small, open economy, the international and domestic price-ratio). In fact, such a welfare-improving wage subsidy will exist in the immediate neighbourhood of  $Q$ .

Theorem III: The full-employment wage subsidy may not be the "second-best" wage subsidy.

The wage subsidy that secures full employment may not also be the wage subsidy that yields the "second-best" welfare maximum (for our social utility function). It is the second-best subsidy in Figure 2; but in Figure 3, it is not.

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\* That increasing wage subsidies in manufacturing should increase  $X_M$  is obvious; however,  $X_A$  may fall or rise.

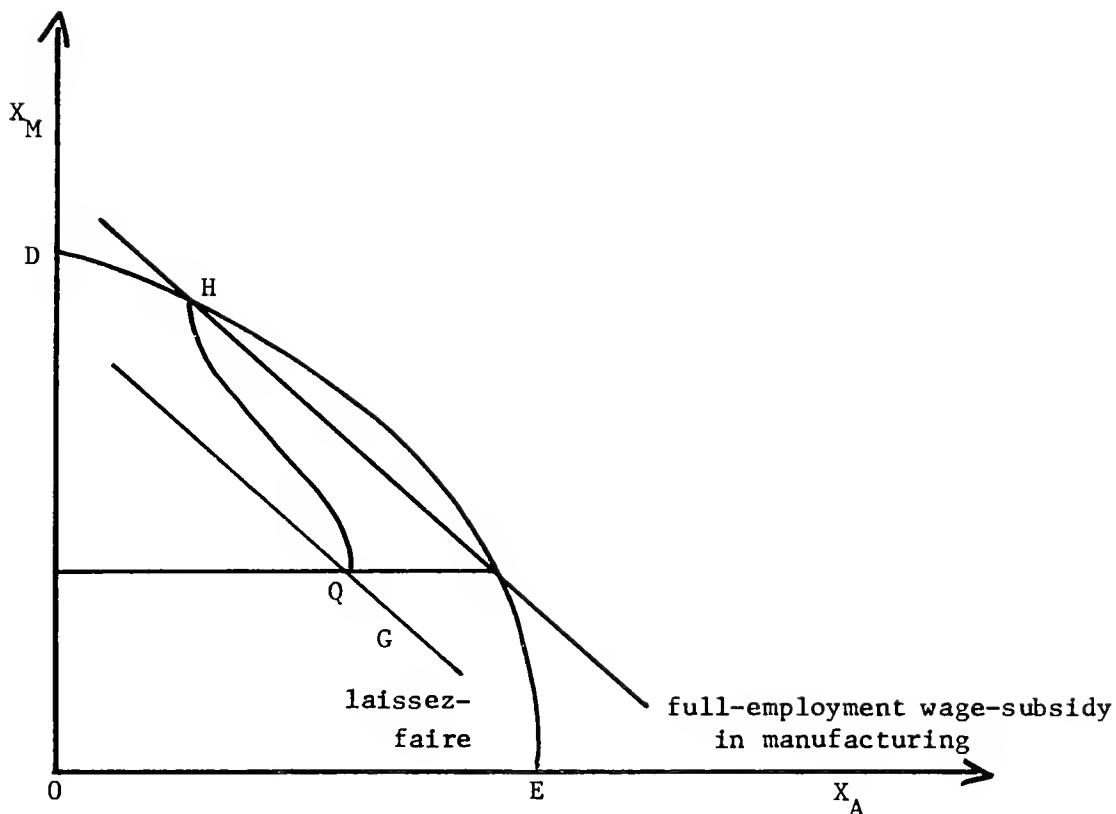


Figure 2

DE is the production possibility curve when the wage rigidity is absent. Q is the laissez-faire production point under the wage constraint. QH is the locus of production equilibria mapped out by successively increasing wage subsidy in manufacturing. Here we have a case where the full-employment wage-subsidy in manufacturing is also at the second-best level.

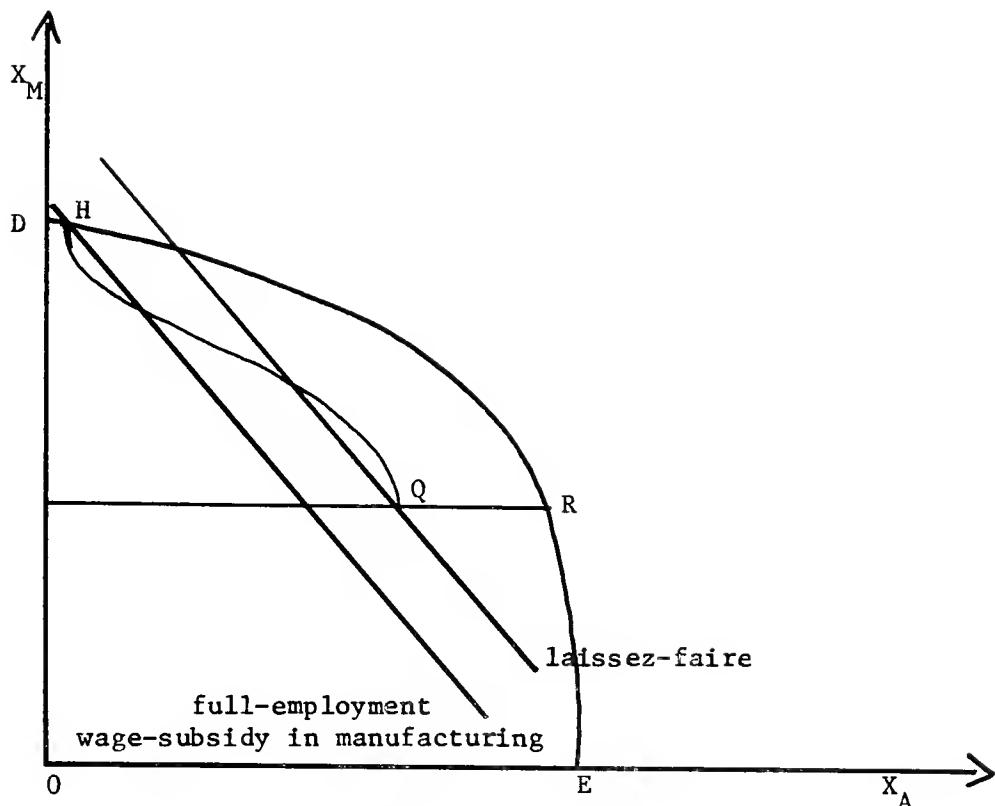


Figure 3

$DE$  is the production possibility curve when the wage rigidity is absent.  $Q$  is the laissez-faire production point under the wage constraint.  $QH$  is the locus of production equilibria mapped out by successively increasing wage subsidy in manufacturing. Here we have a case where the full-employment wage-subsidy in manufacturing (1) is not the second-best subsidy and (2) is also inferior to laissez-faire.

Theorem IV: The full-employment wage subsidy may be inferior to laissez-faire.

The case where the full-employment-yielding wage subsidy (in manufacturing is inferior to laissez faire is illustrated in Figure 3.

Theorem V: There exists a unique production tax-cum-subsidy which will enable full employment to be reached and which is also the second-best tax-cum-subsidy.

Figure 4 illustrates the production tax-cum-subsidy, as the difference between  $RR'$  (the price-ratio in consumption =  $U_1/U_2$ ) and  $RR''$  (the tangent to  $DE$  at  $R$ , defining the producer's price-ratio or alternatively the "domestic rate of transformation"). Clearly, this is both a full-employment and the second-best production tax-cum-subsidy.

Remark: It is also clear that laissez faire is necessarily inferior to a production tax-cum-subsidy policy.\*

Theorem VI: The second-best wage-subsidy (to manufacturing) and the second-best production tax-cum-subsidy cannot be ranked uniquely.

Figure 5 illustrates Theorem VI. If the wage-subsidy locus is  $QH_2$ , it is clear that the second-best wage-subsidy at  $H_2$  dominates the second-best production subsidy to agriculture at  $R$ ; and, if the wage-subsidy locus is alternatively  $QH_1$ , the second-best wage subsidy at  $J$  is dominated by the second-best production subsidy to agriculture at  $R$ .

Theorem VII: The first-best optimum can be reached if both the production tax-cum-subsidy and wage subsidy (to manufacturing) policies are admissible (or any equivalents thereof, including a uniform wage subsidy on employment of labour in both sectors).

\* Recall here also the equivalence propositions listed at the beginning of this section.

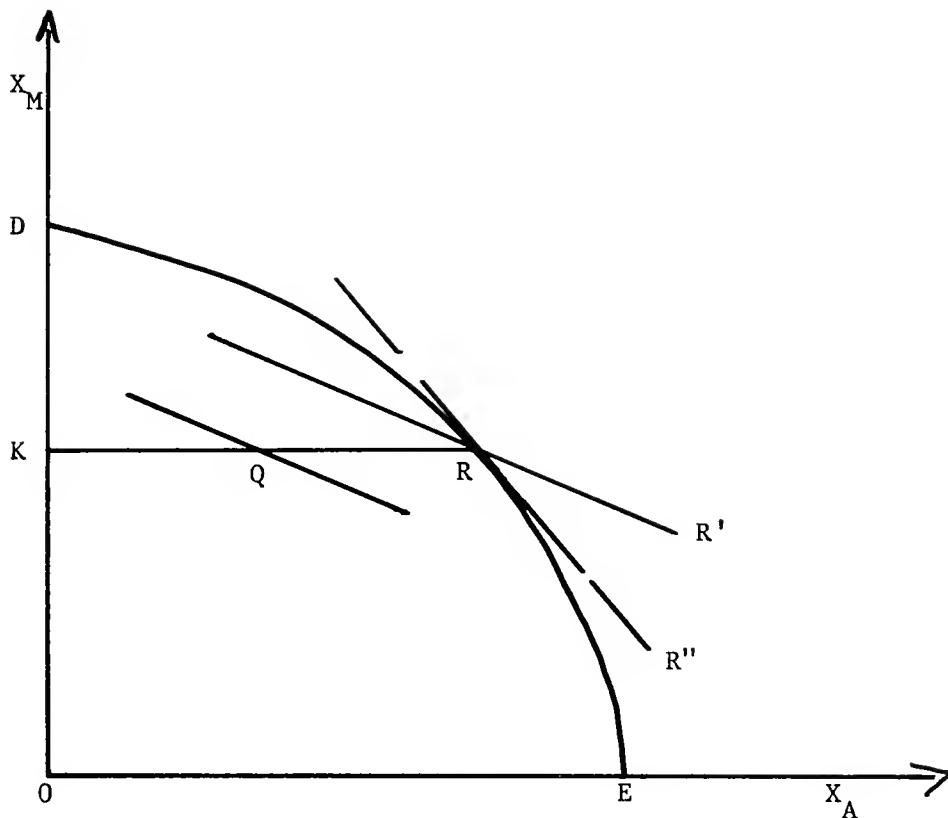


Figure 4

DE is the production possibility curve without the wage constraint; KRE is the curve with the wage constraint. Under laissez-faire, production equilibrium (at price-ratio RR') is at Q. A production or consumption tax-cum-subsidy, defined by the difference between RR' and RR'' (the tangent to DE at R) will take production to R. This policy, under which the tax-cum-subsidy is being clearly levied at its (second-) best level, will necessarily dominate laissez faire (at Q).

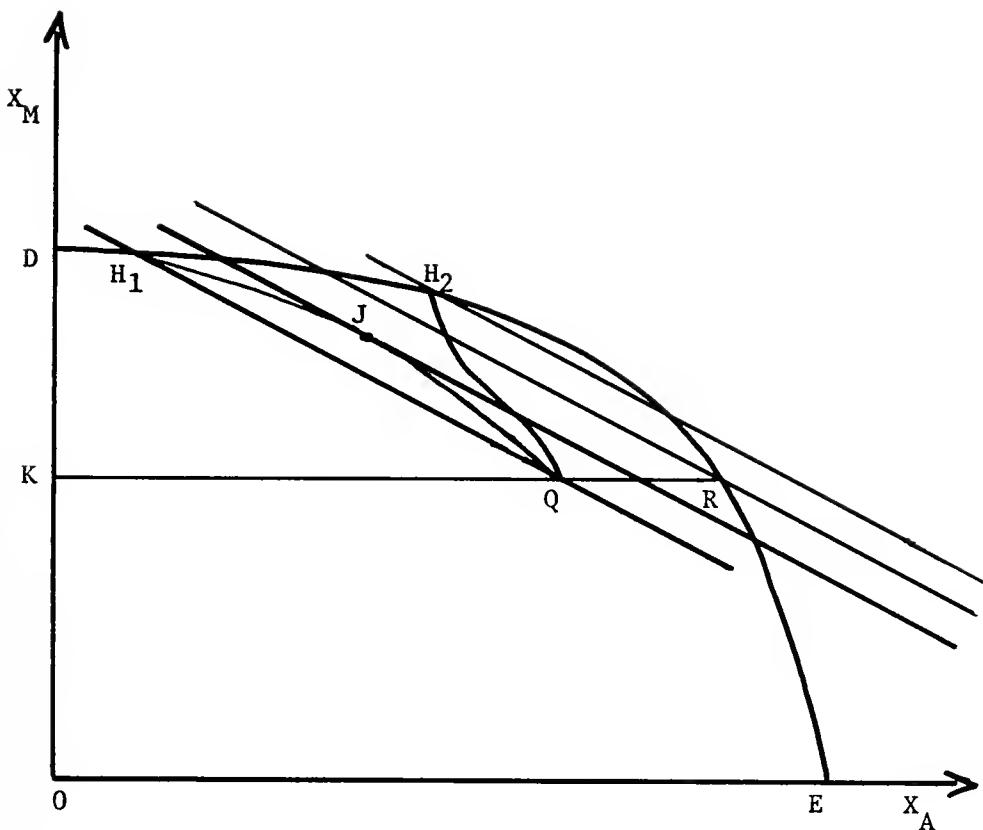


Figure 5

DE is the production possibility curve without the wage constraint; laissez-faire equilibrium production is at Q with the wage constraint. QH<sub>1</sub> and QH<sub>2</sub> are two alternative wage-subsidy-to-manufacturing production loci, derived as in Figure 1. R is the equilibrium production that can be reached by a suitable consumption (or production) tax-cum-subsidy. For QH<sub>1</sub>, then, the (second-) best consumption tax-cum-subsidy policy (at R) will dominate the (second-) best wage-subsidy policy (at J), as also of course the full-employment wage-subsidy policy (at H<sub>1</sub>). For QH<sub>2</sub>, however, the (second-) best wage-subsidy policy (at H<sub>2</sub>), which also happens to achieve full employment, will dominate the (second-) best consumption tax-cum-subsidy policy (at R). Thus, the two policies cannot be uniquely ranked, in general.

### III: Wage Subsidy in Manufacturing

Let us now consider the wage tax-cum-subsidy as the policy intervention in this economy. Denoting by  $s$  the subsidy per unit of labour employed in manufacturing, we find that the equilibrium is now characterised by:

$$f_M' = \bar{w} - s \quad (10)$$

$$\frac{U_1}{U_2} \cdot f_A' = \bar{w} \cdot \frac{L_M}{1-L_A} \quad (11)$$

Equation (10) assumes that each worker in manufacturing receives remuneration  $\bar{w}$ , of which only  $(\bar{w}-s)$  is paid by the employer and  $s$  by the State out of lump-sum taxation. With the consumer and producer price of the agricultural good assumed to be identical, and equal to  $U_1/U_2$ , we then have the actual wage in agriculture being equated to the employment-rate-weighted (i.e. expected) wage in manufacturing in equation (11).

It is clear then that, given  $\bar{w}$  and  $s$ , we can solve for  $L_M$  and  $L_A$  from (10) and (11). Thus, given concavity,  $L_M$  is determined uniquely by (10) for  $0 \leq s \leq \bar{w}$ . Given  $L_M$ ,  $X_M$  is determined and hence both the left and right hand sides of (11) are functions of  $L_A$  only.

Now, the right hand side is clearly an increasing function of  $L_A$ . We next proceed to show that the left hand side is a decreasing function of  $L_A$ . Note that the derivative of the left hand side with respect to  $L_A$  is:

$$\left( \frac{U_{11}U_2 - U_{21}U_1}{U_2^2} \right) \left( f_A' \right)^2 + \frac{U_1}{U_2} f_A''$$

Now,  $U_1$ ,  $U_2$ , and  $f_A'$  are positive and  $f_A''$  is negative because of concavity of  $f_A$ . The term involving the second partial derivatives of  $U$  vanishes if  $U$  is linear. If  $U$  is non-linear in  $X_A$ , then its concavity ensures that  $U_{11} < 0$ .

If we assume  $U_{12} \geq 0$ , i.e. the marginal utility of either good does not fall if the consumption of the other good is increased, we will then ensure that the left hand side of (11) is a decreasing function of  $L_A$ .

Noting next that the relevant range for  $L_A$  is clearly  $\{0, 1-L_M(s)\}$ , we can graph the two sides of (11) in Figure 6 for two values of  $s$ :  $s_1$  and  $s_2 (> s_1)$ . We now have to show that, given  $s$ , the graphs of the two sides of (11) will intersect at a unique value of  $L_A(s)$  and to verify that this value lies in the relevant range  $\{0, 1-L_M(s)\}$ . This is done readily, as follows.

Note first that, because of the concavity of  $f_M$ ,  $L_M(s)$  is an increasing function of  $s$  and hence, for given  $L_A$ , the right hand side of (11) is an increasing function of  $s$ . The partial derivative of the left hand side of (11) with respect to  $s$  is:

$$\left( \frac{U_{12}U_2 - U_{22}U_1}{U_2^2} \right) f'_A f'_M \frac{dL_M(s)}{ds}$$

which is zero if  $U$  is linear in  $X_A$  and  $X_M$ , and negative if  $U$  is non-linear in  $X_M$  and concave provided (as we assumed earlier)  $U_{12} \geq 0$ . Thus, the graph of the right hand side of (11) shifts to the left and that of the left hand side either stays put (if  $U$  linear in  $X_A$  and  $X_M$ ) or shifts to the right as the subsidy  $s$  is increased.

We can next readily demonstrate that a unique laissez-faire equilibrium, characterised by unemployment, exists. As noted earlier, the relevant range for  $L_A$ , given  $s = 0$ , is  $\{0, 1-L_M(0)\}$ . As  $L_A \rightarrow 0$   $f'_A \rightarrow \infty$ , and  $U_1/U_2$  either remains constant or increases (given  $U_{12} \geq 0$ ). Thus  $\lim_{U_2} \frac{1}{U_2} f'_A = \infty$ .

But  $\lim_{L_A \rightarrow 0} \bar{w} \frac{L_M(0)}{1-L_A} = \bar{w}L_M(0) < \lim_{L_A \rightarrow 0} \frac{U_1}{U_2} f'_A$ . In other words, the graph of the

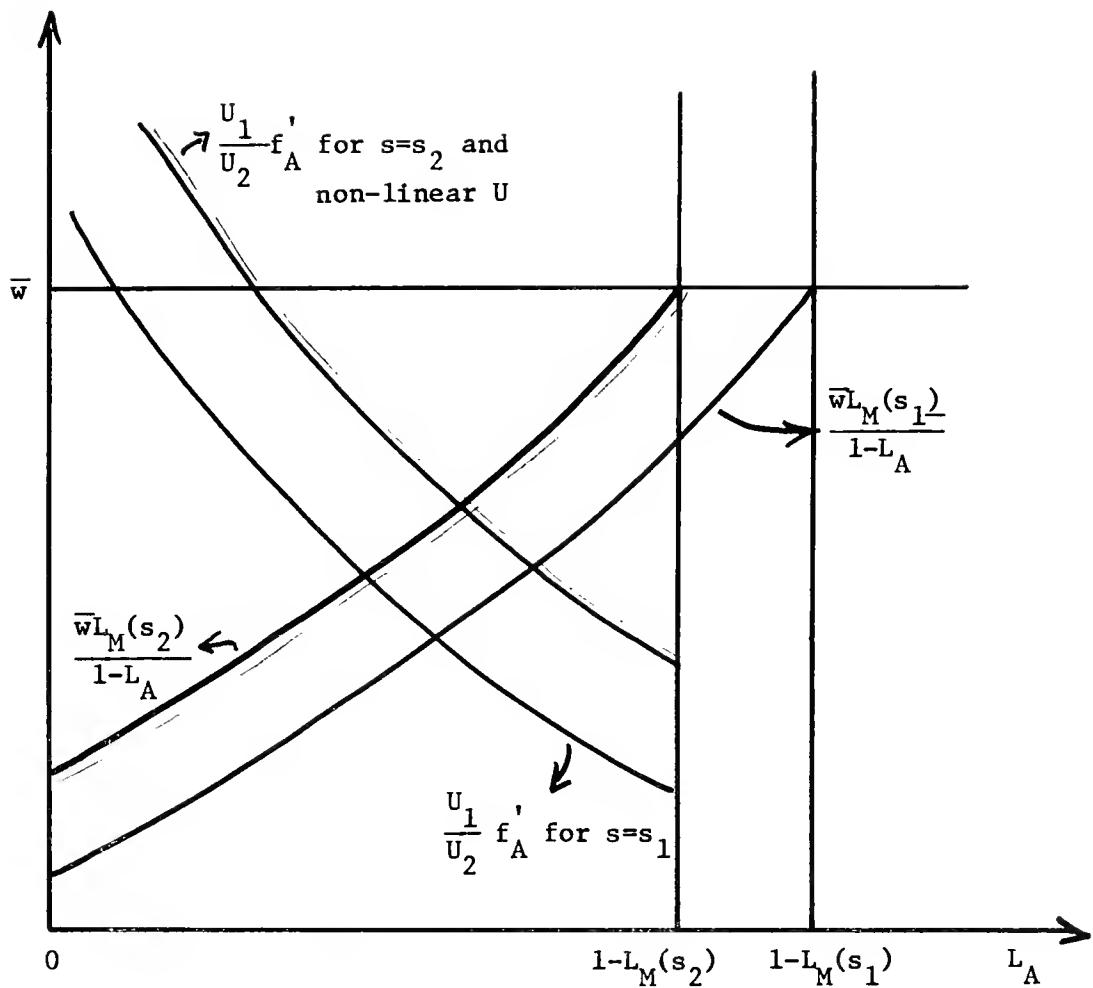


Figure 6

left hand side of (11) lies above that of the right hand side near  $L_A = 0$ .

At  $L_A \rightarrow 1-L_M(0)$ , the right hand side has the value  $\bar{w}$  and the left hand side has the value  $\frac{U_1}{U_2} f'_A \Big|_{1-L_M(0), L_M(0)}$ , i.e.  $\frac{U_1}{U_2} f'_A$  evaluated at  $L_A = 1-L_M(0)$  and  $L_M = L_M(0)$ . But this value of  $\frac{U_1}{U_2} f'_A$  is less than that at the unconstrained optimum point  $L_A^* = 1-L_M^*$ ,  $L_M^*$ ; since  $L_M^* < L_M(0)$  (reflecting the fact that  $f'_M(L_M(0)) = \bar{w}$  while  $f'_M(L_M^*) < \bar{w}$ ) it follows that  $L_A^* > L_A^0$ . But  $\frac{U_1}{U_2} f'_A \Big|_{1-L_M^*, L_M^*} = f'_M \Big|_{L_M^*} < \bar{w}$ . Hence  $\frac{U_1}{U_2} f'_A \Big|_{1-L_M(0), L_M(0)} < \frac{U_1}{U_2} f'_A \Big|_{1-L_M^*, L_M^*} < \bar{w}$ . This means that, at  $L_A = L_A(0)$ , the graph of the left hand side of (11) is below that of the right hand side. Hence the two graphs intersect at a unique value  $L_A(0)$  which lies between 0 and  $1-L_M(0)$ . In other words, there exists a unique laissez-faire equilibrium characterised by unemployment.

It is then easily seen that, as we introduce and increase a wage subsidy (to manufacturing)  $s$  from this unemployment, laissez faire equilibrium, the graphs of the two sides of (11) in Figure 6 continue to shift and intersect at an  $L_A(s)$  in the interval  $\{0, 1-L_M(s)\}$  until  $s$  attains a value  $\bar{s}$  when the two graphs, the horizontal line at  $\bar{w}$  and the vertical line through  $1-L_M(s)$  all intersect at the same point, as shown in Figure 7. Since this implies that  $L_A(\bar{s}) = 1-L_M(\bar{s})$ , there is clearly full employment at this equilibrium: i.e. at a wage subsidy,  $s = \bar{s}$ , full employment can be obtained.

While the preceding argument establishes the existence of a full-employment-yielding wage subsidy, we now show that: (1) it need not be the second-best wage subsidy; (2) it may not even be welfare-improving over laissez-faire; and (3) some wage subsidy will always improve welfare over laissez faire. To establish these propositions, note that:

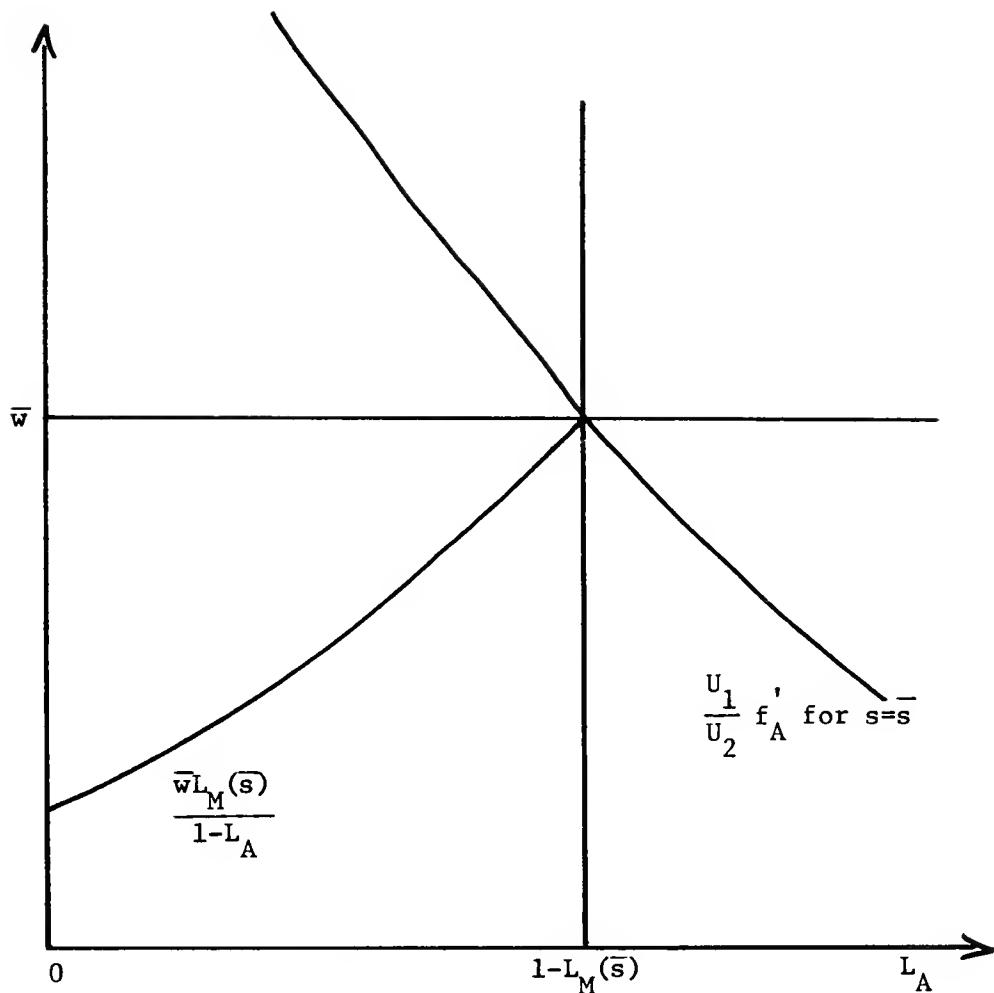


Figure 7

$$\frac{dU}{ds} = U_1 f_A' \frac{dL_A(s)}{ds} + U_2 f_M' \frac{dL_M(s)}{ds}$$

We see from (10) that  $\frac{dL_M(s)}{ds} = -\frac{1}{w} > 0$ . From (11), we can next see that:

$$\begin{aligned} \frac{dL_A(s)}{ds} &= \left\{ \frac{\bar{w}}{1-L_A} - f_A' f_M' \frac{(U_{12}U_2 - U_{22}U_1)}{U_2^2} \right\} \frac{dL_M}{ds} \\ &\quad \left[ \frac{U_1}{U_2} f_A'' + \left( \frac{U_{11}U_2 - U_{12}U_1}{U_2^2} \right) (f_A')^2 - \frac{\bar{w}L_A}{(1-L_A)^2} \right] \end{aligned}$$

The denominator of this expression is negative but the sign of the numerator is positive if  $U$  is linear but indeterminate if  $U$  is non-linear. Substituting this in the expression for  $\frac{dU}{ds}$ , and using (10) and (11), we then get:

$$\begin{aligned} \frac{dU}{ds} &= \frac{U_2 \left[ \frac{\bar{w}L_M}{1-L_A} \left\{ \frac{\bar{w}}{1-L_A} - f_A' f_M' \left( \frac{U_{12}U_2 - U_{22}U_1}{U_2^2} \right) \right\} + (\bar{w}-s) \left\{ \frac{U_1}{U_2} f_A'' + \left( \frac{U_{11}U_2 - U_{21}U_1}{U_2^2} \right) (f_A')^2 - \frac{\bar{w}L_M}{(1-L_A)^2} \right\} \right]}{\left[ \frac{U_1}{U_2} f_A'' + \left( \frac{U_{11}U_2 - U_{12}U_1}{U_2^2} \right) (f_A')^2 - \frac{\bar{w}L_M}{(1-L_A)^2} \right]} \\ &= \frac{U_2 \left[ \frac{\bar{w}L_M}{(1-L_A)^2} + (\bar{w}-s) \frac{U_1}{U_2} f_A'' - \left( \frac{\bar{w}L_M}{1-L_A} \right) f_A' f_M' \left( \frac{U_{11}U_2 - U_{22}U_1}{U_2^2} \right) + (\bar{w}-s) \left( \frac{U_{11}U_2 - U_{21}U_1}{U_2^2} \right) (f_A')^2 \right]}{\left[ \frac{U_1}{U_2} f_A'' + \left( \frac{U_{11}U_2 - U_{12}U_1}{U_2^2} \right) (f_A')^2 - \frac{\bar{w}L_M}{(1-L_A)^2} \right]} \end{aligned}$$

The sign of  $\frac{dU}{ds}$  is clearly indeterminate even if  $U$  is linear because the numerator is of indeterminate sign though the denominator is negative.

However, not all is lost. For, all terms except for  $\bar{w}L_M/(1-L_A)^2$  are negative in the numerator; and this term should vanish when  $s = 0$ . Hence  $\frac{dU}{ds} > 0$  when  $s = 0$ , i.e. under laissez faire: in other words, laissez faire is a sub-optimal policy and a wage subsidy would be welfare-improving.

It is also clear that the full-employment-yielding subsidy  $\bar{s}$  may not be the second-best optimal subsidy, and that it need not even be superior to laissez-faire.

#### IV: Production Tax-cum-Subsidy

We now consider the policy of subsidising production in agriculture. To do this, we must now rewrite the equilibrium conditions as follows:

$$f'_M = \bar{w} \quad (12)$$

$$\pi_p f'_A = \frac{\bar{w} L_M}{1 - L_A} \quad (13)$$

where  $\pi_p$  is the producer's price of the agricultural good, so that the implied production tax-cum-subsidy can be derived as  $[\pi_p - U_1]/U_2$   $\left( \frac{U_1}{U_2} \right)$ .

As before, (12) yields a unique value  $\bar{L}_M$  for  $L_M$ . Again, as in the case of (11), the left hand side of (13) is a decreasing function of  $L_A$  and the right hand side is an increasing function of  $L_A$ . And the two sides are graphed in Figure 8. Note again that the left hand side of (13) is an increasing function of  $\pi_p$ , for given  $L_A$ , and the right hand side now is independent of  $\pi_p$ .

Hence, for each  $\pi_p$  in  $(0, \bar{\pi}_p)$ , where  $\bar{\pi}_p f'_A = \bar{w}$  (i.e.  $\bar{\pi}_p$  is the price-ratio that yields full employment), a unique  $L_A(\pi_p)$  exists that satisfies (13) and lies in the range  $(0, 1 - \bar{L}_M)$ .

The laissez faire value of  $\pi_p$  equals  $U_1/U_2$  where  $\frac{U_1}{U_2} f'_A = \frac{\bar{w} L_M}{1 - L_A}$ . As  $\pi_p$  increases, furthermore, it is evident from both Figure 8 and the underlying algebra, that  $L_A$  increases as well, thus increasing  $X_A$ , while  $X_M$  remains unchanged because  $L_M$  remains unchanged at  $\bar{L}_M$ . Hence both economic welfare ( $U$ ) and employment clearly increase as  $\pi_p$  is increased from its laissez faire

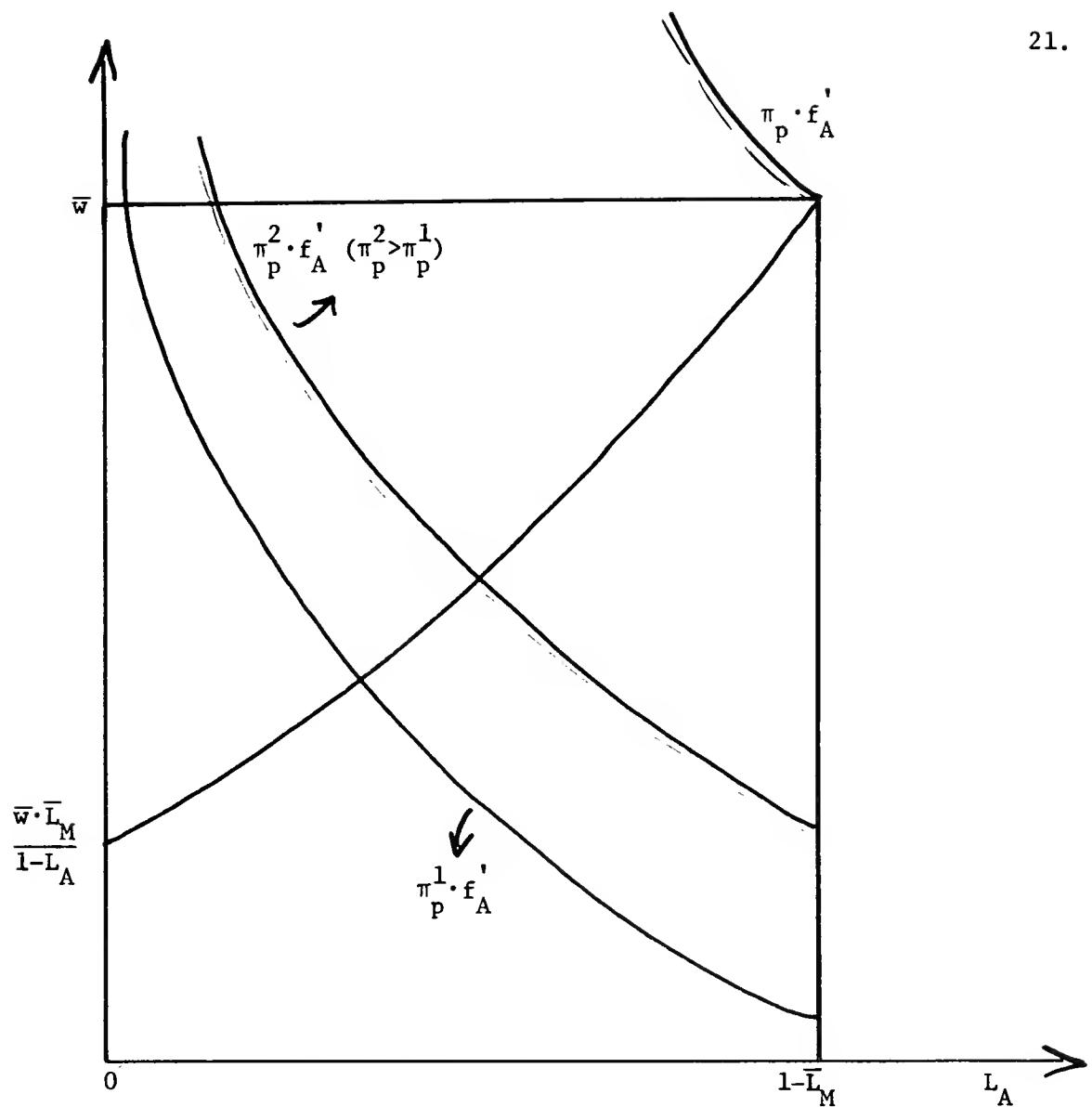


Figure 8

value to  $\bar{\pi}_p$ , its full-employment value. Thus clearly the second-best optimum is attained when  $\pi_p = \bar{\pi}_p$ .<sup>\*</sup>

Note finally that we are not able to rank the second-best optimum wage subsidy (to manufacturing) and the second-best production subsidy to agriculture.<sup>\*\*</sup>

#### V: Optimal Policy Intervention

Finally, it is easily demonstrated that if the two policies (considered in Sections III and IV) can be simultaneously applied, the first-best optimum can be reached.

This is done simply by determining the optimum levels of the two instruments and showing that the necessary constraints are met. Thus, let:

$$s^* = \bar{w} - f_M'(L_M^*)$$

be the wage subsidy. Let:

$$\pi_p^* = \frac{\bar{w}}{f_A'(L_A^*)}$$

be the producer's price of the agricultural good. Let:

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<sup>\*</sup> It is easy to see that the laissez faire value of  $\pi_p$  is strictly less than  $\bar{\pi}_p$ . For, if it were the same, then we would have  $\bar{\pi}_p f_A' = f_M'$ , and  $\bar{\pi}_p = U_1/U_2$ , so that  $U_1/U_2 = f_M'/f_A'$ , which is impossible because this condition can obtain in full employment only at the first-best optimum--a situation ruled out by the fact that laissez faire is assumed to be characterised by a binding, rigid-wage constraint.

<sup>\*\*</sup> In fact, we have been able merely to prove the existence of a second-best wage subsidy, without being able to determine its value explicitly.

$$\pi_c^* = \frac{U_1^*(x_A^*, x_M^*)}{U_2^*(x_A^*, x_M^*)}$$

by the consumption price of the agricultural good, such that

$$t^* = \frac{\pi_p^* - \pi_c^*}{\pi_c^*}$$

is the optimal production subsidy to agriculture. With these values for  $s^*$  and  $\pi_p^*$ , we have:

$$f_M' = \bar{w} - s^* \quad (14)$$

$$\pi_p^* f_A' = \bar{w} = \bar{w} \cdot \frac{L_M^*}{1 - L_A^*} \quad (15)$$

so that it is clear that the constraints in the model are met (i.e. the wage rate in manufacturing is at  $\bar{w}$ , and the wage rates are equalised at the producer's prices in both sectors) and full-employment, optimal equilibrium is reached with wage subsidy at level  $s^*$  and production subsidy to agriculture at rate  $t^*$ .

Note also that the same optimal equilibrium can be equivalently obtained by dropping the production subsidy and instead extending the wage subsidy at level  $s^*$  to agricultural employment as well. In this case, we should write:

$$f_M' = \bar{w} - s^* \quad (16)$$

$$\pi_c^* \cdot f_A' = \bar{w} - s^* \quad (17)$$

In either case, the equilibrium production will be identical. However, as illustrated in Figure 9, where S is the first-best optimum for a closed economy, production under the uniform wage subsidy will be given by the

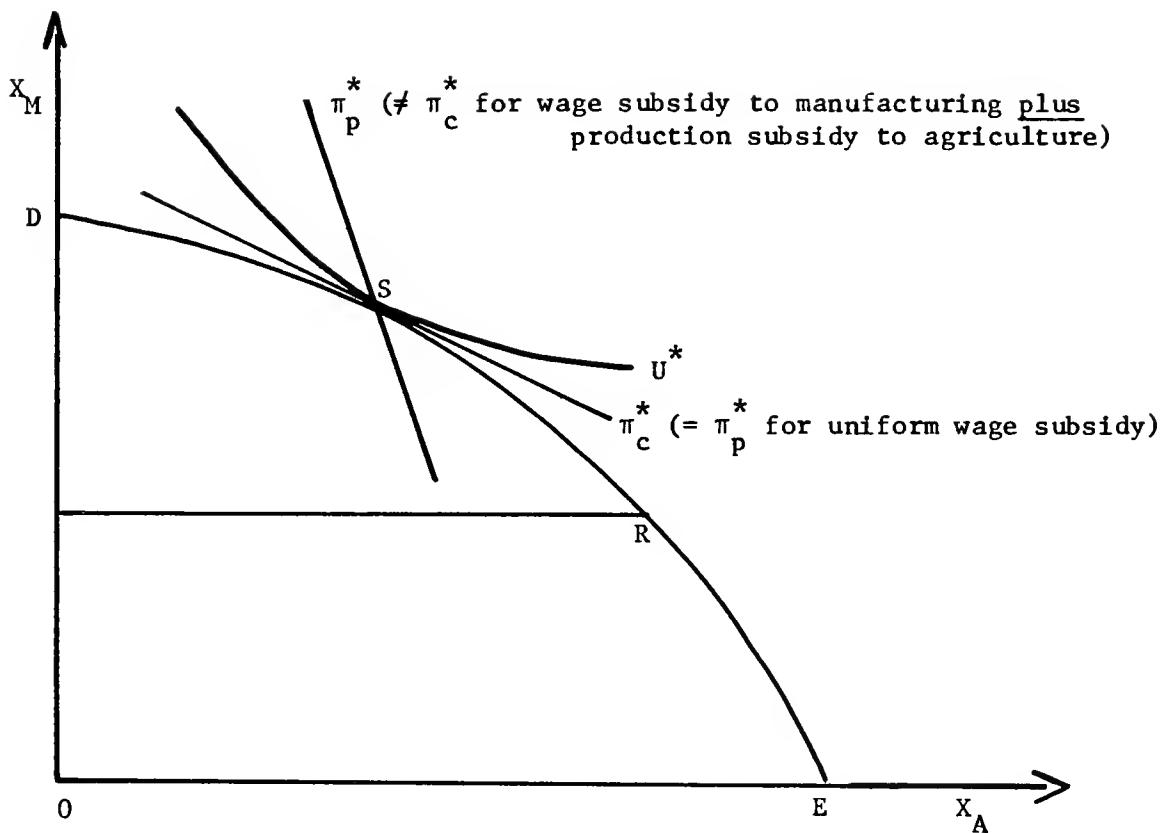


Figure 9

$S$  is the first-best, optimum for a closed economy, with the social utility curve  $U^*$  tangent to the production possibility curve  $DE$ . A suitable, uniform wage subsidy to both sectors,  $A$  and  $M$ , will equate the consumption and production prices with the domestic rates of transformation in production and substitution in consumption at  $S$ . A suitable wage subsidy to manufacturing plus production subsidy to agriculture will not equate the consumption and production prices but will equate the two rates of substitution in consumption and transformation in production at  $S$  with each other and with the consumption price alone.

tangency of  $\pi_p^*$  to the production possibility curve DE whereas, under the wage subsidy (to manufacturing) plus production subsidy to agriculture, it will be characterised by non-tangency of  $\pi_p^*$  to DE at S.

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